

**DATE:** February 16, 2023

**TO:** Portland Business Alliance

**RE:** Multnomah County Ballot Measure 26-238

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## Summary

Financial and investment markets are inherently volatile. As such, a tax on the potential gains is not a stable source of revenue to fund any public service programs. There are many things to consider before implementing the proposed local capital gains policy. Important factors such as the impact it may have on seniors, small and medium sized business owners, and the middle class should be analyzed. Further, it could have unintended consequences on both the business community and residents of Multnomah County outside the scope of this analysis. These potential consequences should be examined further as well as the costs associated with such regime before proceeding.

## Overview

Multnomah County Ballot Measure 26-238, "Eviction Representation for All" was qualified to appear on the May 16, 2023, ballot. If passed, this measure would create a program that:

provides free, culturally specific and responsive legal representation, with translation, to persons sued in Multnomah County residential proceedings (including post foreclosure) as well as related housing claims and appeals, including to maintain public housing assistance.<sup>1</sup>

This initiative intends to fund the proposed Eviction Representation for All ("ERA") program by establishing a new capital gains tax. The measure provides that:

A new, adjustable 0.75 percent tax on net capital gains (as defined by the Internal Revenue Code) of County residents to fund the program... Businesses are not subject to the tax. The tax rate may be increased or decreased based on the County's annual reports.<sup>2</sup>

The remainder of this memorandum will focus on the possible implications should voters approve the measure which will adopt the proposed net capital gains tax.

## Analysis

The ERA intends to impose a tax on "net capital gains tax as defined by the Internal Revenue Code." Internal Revenue Code ("IRC") § 1222(11) defines the term "net capital gains" as the excess of the net long-term capital gain for the taxable year over the net-short term capital loss for such year. Additionally, IRC § 1222 provides that:

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<sup>1</sup> MultCollInt-09 Ballot Title and Explanatory Statement

<sup>2</sup> MultCollInt-09 Ballot Title and Explanatory Statement



(4) The term “net long-term capital gain” means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

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(6) The term “net short-term capital loss” means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

Generally, short-term capital gains are from the sale or exchange of a capital asset held for not more than 1 year, whereas a long-term capital gain is the gain from the sale or exchange of a capital asset held for more than 1 year.

The term “capital asset” as defined in IRC § 1221, means:

property held by the taxpayer (whether or not connected with his trade or business), but generally does not include—

1. Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
2. Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
3. A patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property,
4. Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property...
5. A publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—
6. Any commodities derivative financial instrument held by a commodities derivatives dealer, subject to specific exclusions
7. Any hedging transaction that is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or
8. Supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

In general, anything held for personal or investment purposes is considered to be a capital asset. This includes a home, furnishings, vehicles, stocks or bonds held as investments. When a capital asset is sold, the difference between the adjusted basis and the amount realized from the sale is a capital gain or capital loss.<sup>3</sup>

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<sup>3</sup> Internal Revenue Service, *Topic No. 409 Capital Gains and Losses*



## Discussion

The proposed ERA capital gains tax intends to impose a tax on the net gain on the sale of capital assets as defined by the Internal Revenue Code ("IRC"). Due to the seemingly simplistic nature of this tax as proposed, we believe there may be several unintended consequences making this tax anything but simple.

Unlike the IRC, the proposed ERA capital gains tax will be a single rate that may be adjusted, but likely increased, regardless of income levels. This is in contrast to the IRC which provides that individuals in the lowest income tax brackets may have capital gains taxed at a 0 percent rate. While the IRC capital gains tax rate increases, it does so as taxable income increases, following a progressive rate structure which is featured throughout all of the federal income tax code. The proposed local capital gains tax rate may also increase, but not according to a progressive rate structure. Since the proposed local capital gains tax rate is not tied to income levels, taxpayers would be subject to this tax even if they were otherwise nontaxable for federal, Oregon, and other local tax purposes. For instance, as seniors withdraw savings from retirement investment accounts, they may not be subject to federal or Oregon income taxes, but they could pay have to pay the ERA capital gains tax on the savings which would reduce their retirement income if their withdrawals are categorized as capital gains.

Although this tax is intended to be imposed on individuals, we believe this tax would also apply to small and medium-sized business owners. Businesses organized as pass-through entities such as a sole proprietorship, partnership, limited liability company (except those electing to be taxed as a C corporation), and S corporation are taxed at the individual level. The majority of Multnomah County small business owners reflect the annual activity of their businesses on their individual income tax returns. In the event that a Multnomah County business owner must sell their business, which represents their entire net worth, due to personal hardship- for example, to fund medical expenses, or their child's education- will also have to pay this tax with no other investments to offset any gains.

By its very nature, a net capital gains tax is applied to the profits on investments sold in a tax year. As such, residents who sell profitable securities may offset their gains by also selling securities that have lost money. Small business owners or middle-class investors are more likely to invest conservatively. Whereas a wealthy investor is more likely to make riskier investments and have access to sophisticated advice on how to manage their portfolio to avoid taxes. We believe that this could put the small business owner or middle-class investor at a disadvantage and more likely to pay this tax than wealthy residents.

### *Possible Constitutional Issues*

As written, we believe the tax created by Measure 26-238 would only apply to Multnomah County residents. As such, if a resident sells an investment located in another county or state, that resident could be subject to this tax on any gains received. Conversely, we believe that a nonresident may have gains on investments located in Multnomah County that would not be subject to this tax. An example of this would be a Multnomah County business taxed as an S Corporation with a Vancouver, WA resident as the 100 percent owner. We believe that the potential capital gain on the sale of the business would not be subject to this tax because the owner's individual tax return would be filed as a nonresident of Multnomah County. Not only could this be an incentive for a resident to move outside of the county, but this may also present constitutional issues under the Commerce Clause. The Commerce Clause of the U.S. Constitution prohibits states from enacting laws that might unduly burden or inhibit the free flow of



commerce between the states. Should the tax be imposed on residents with capital gains from assets located outside of the county this may be considered discriminatory.<sup>4</sup>

### *Principal Residence Exclusion*

We believe the ERA capital gains tax will not allow for exclusions of gain from the sale of principal residence, which may cause certain groups to experience additional hardship. IRC § 121 provides an exclusion from the capital gains tax for sale of a principal residence. More specifically, if a taxpayer sells their principal residence for which they lived in 2 years or more during the 5-year period preceding the date of the sale, \$250,000 (\$500,000 if filing a joint return) may be excluded from the gain.

Since the Multnomah County capital gains tax is based only on the IRC definition of net capital gains, and does not include language regarding exclusions, we believe that residents selling their home would not benefit from the exclusion on the sale of their principal residence and would owe the proposed local capital gains tax on all gains from the sale. This tax could not only disincentivize home ownership in Multnomah County, but could also negatively impact senior residents of the county.

Seniors often rely on the equity in their homes as a source of retirement income. Any appreciation on their home, which they might have lived in for the past several decades, would be subject to this capital gains tax. If a senior needed to sell their home to downsize, relocate to a more affordable area, pay for healthcare or end of life costs, this tax would impact them. They would retain less proceeds on the sale of their home due to this tax. This could make it difficult for them to afford housing in their desired location, impact their ability to maintain their standard of living in retirement, or limit their options for healthcare. For example, if a retired couple decided to sell and downsize their home which appreciated \$500,000 since purchasing the home thirty years ago, the couple would be able to take advantage of the principal residence exclusion and pay no capital gains tax on their Federal, Oregon and local income tax returns. However, if this tax is passed, they would have to pay 75 cents on every \$100 of appreciation to Multnomah County.

### *Volatile, Cumbersome, and Costly*

Capital gains taxes are volatile and unpredictable sources of revenue, making it difficult to budget accurately to fund programs. The tax base for a capital gains tax is generally net gains realized on the difference between the adjusted basis and the sales price. Fluctuations in financial markets make it challenging to predict whether assets or investments will appreciate. This volatility could lead to political pressure to increase the local capital gains tax rate or to impose new taxes to make up for revenue shortfalls that could be created by market and spending pattern changes.

Residents in Multnomah County already have to navigate through an overly cumbersome state and local tax environment. A resident small business owner currently has to comply with a minimum of eight different taxes including federal income tax, Oregon state income tax, Oregon's Metro income tax, Portland/Multnomah County business income tax, Corporate Activity Tax (CAT), Preschool for All tax, Supportive Housing Services tax (individual), and the Arts Tax. The combined result of these taxes means that Multnomah County has the second highest marginal individual income tax rate in the United States after New York City. Unlike New York City where the highest tax bracket begins at \$25 million, the highest tax brackets for Multnomah County residents begins at taxable income of \$250,000 for individual

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<sup>4</sup> U.S. Const. Art. I, §6, cl. 3



tax filers, and \$400,000 for joint filers. If the ERA capital gains tax passes, a Portland small business owner may face an all-in state and local tax rate of over 26.2 percent. Combined with federal income taxes, the typical small business owner could pay a 67.1 percent tax rate.<sup>5</sup> This says nothing of other taxes including property tax and indirect taxes such as fuel, excise, etc. Should the small business owner need to sell investments such as a portion of their business in order to stay afloat after struggling through the COVID-19 pandemic, supply chain issues, and inflation will have its proceeds further eroded by this tax. Every additional level of tax contributes to increased costs that a small business owner must pay.

Most state tax structures start with either an amount reported on a specific line appearing on the federal tax return or gross receipts of the business. This tax on “net capital gains” as defined in the Internal Revenue Code is a term that does not appear on any other return. This would contribute to taxpayer confusion and increased difficulty for taxpayers to comply due to varying models. Further, unlike other state and local tax structures, this local capital gains tax does not provide any relief for paying tax under other tax regimes (e.g., Preschool for All, Metro jurisdiction) resulting in multiple layers of taxation amongst the state and local levels.

Creating and maintaining a tax program comes with administrative costs that should be considered. Using the City of Portland’s Arts Tax as an example, it was expected that administrative costs would not exceed an average of 5 percent of the programs’ gross revenues over a five-year period plus a one-time startup costs not to exceed \$600,000.<sup>6</sup> While the Arts Tax program came in about \$11,000 under budget for one-time startup costs, the program routinely exceeds in administrative costs at 11 percent of total revenue.<sup>7</sup> Given that this tax is anything but simple, this could mean that the costs would be even higher due to the processing of a separate return for the County, developing a filing system, monitoring compliance, issuing notices, auditing returns in addition to providing taxpayer education and responding to inquiries. The difference in expenses under the Arts Tax program between what was expected in comparison to actual should highlight that imposing a new tax, which due to its complexities could have even higher administration costs than anticipated and should be fully vetted before proposing a new tax.

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<sup>5</sup> Oregon Legis., House Bill 2673, Reg. Sess. 2023, which is currently before the House Committee on Revenue, proposes to increase the marginal tax rate and add a new tax bracket with a higher marginal rate for Oregon income taxes. It would require a three-fifths majority vote to pass. Should it pass, the all-in state and local income tax rate for Portland small business owner would increase to over 70.1 percent.

<sup>6</sup> City of Portland Revenue Bureau, Office of Management and Finance. (2014) *Arts Education and Access Income, Tax Year 2012 Compliance, Collections, Disbursements & Costs*.

<sup>7</sup> City of Portland Revenue Bureau, Office of Management and Finance. (2022) *Arts Education and Access Fund, Revenues, Collection Costs & Disbursements*, Collections as of 03/15/2022.